cutting through complexity

Temporary Regulations Addressing Inversions and Related Transactions and Proposed Section 385 Regulations

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Agenda

Temporary Anti-Inversion Regulations

- Overview & Background
- Section 7874 Regulations
- Out-From-Under Restructuring Transactions

Proposed Section 385 Regulations

- Overview & Background
- Recharacterization Provisions

Temporary Anti-Inversion Regulations

Inversions: Overview

- An "inversion" is a transaction in which a domestic multinational re-domiciles to another jurisdiction
- Two general types of inversion transactions
  - Traditional Inversion: A domestic multinational converts to a foreign corporation or is acquired by a newly created foreign holding company
  - Combination Inversion: A domestic multinational combines with a smaller third party foreign multinational, and the resulting multinational has an ultimate foreign parent after the business combination
- Current anti-inversion rules generally apply to limit traditional inversions except where the resulting multinational group has a substantial business presence in the jurisdiction in which the foreign acquiring corporation was created or organized

Inversions: Overview

- Potential reduction of worldwide tax rate
- Ability to repatriate non-U.S. earnings without incremental risk
  - A U.S. company with low-taxed foreign earnings must pay incremental U.S. tax when those earnings are repatriated to the U.S. parent corporation, which can result in “trapped cash”
  - A non-U.S. domiciled company generally does not encounter the same situation. As such, all earnings are available to support new / additional investment, debt service, and shareholder distributions
- Use of intragroup leverage to reduce tax on U.S. earnings
  - Subject to limitations, the intragroup debt provides interest deductions that potentially reduces U.S. taxable income and increases overall cash flow and earnings
- Other qualitative benefits
  - Better platform for future U.S. and non-U.S. acquisitions
  - Can maintain U.S. primary listing with no investor stigma associated with foreign domicile
  - Potential opportunity to move foreign subsidiaries out from under the U.S. group

Section 7874: In General

- Section 7874 applies to the direct or indirect acquisition by a foreign corporation ("Foreign Acquiring") of ***substantially all*** of either (i) the properties directly or indirectly held by a domestic corporation or (ii) the properties of a trade or business of a domestic partnership (such corporation or partnership, the "Domestic Entity" and such acquisition, the "Domestic Entity Acquisition"), in each case, if:
  - Immediately after the Domestic Entity Acquisition, the former Domestic Entity shareholders/partners have a certain percentage of continued ownership (by vote or value) in Foreign Acquiring ***by reason of*** owning their interests in the Domestic Entity (if expressed as a fraction, the "Ownership Fraction," and if expressed as a percentage, the "Ownership Percentage"); and
  - Foreign Acquiring's expanded affiliated group ("EAG") does not have ***substantial business activities*** in Foreign Acquiring's country of creation or organization as compared to the EAG's worldwide business activities (the "SBA Exception")

Section 7874: In General

- If the Ownership Percentage is at least 80%, Foreign Acquiring is a "surrogate foreign corporation" that is treated as a domestic corporation for all U.S. tax purposes
- If the Ownership Percentage is at least 60% but less than 80% (an "Inversion Transaction"), Foreign Acquiring is a surrogate foreign corporation that is respected as a foreign corporation for U.S. tax purposes
  - The Domestic Entity and certain related U.S. persons are considered "Expatriated Entities"
  - Expatriated Entities are limited in using losses and other U.S. tax attributes with respect to income or gain recognized on certain property transfers and licenses during the Domestic Entity Acquisition and the following 10 years (such income or gain, the "Inversion Gain" and such period, the "Applicable Period")

Section 7874 Regulations

Temporary Section 7874 Regulations: Overview

- The section 7874 regulations provide rules addressing:
  - Certain multiple-step Domestic Entity Acquisitions
  - Clarifying the disqualified stock anti-abuse rules
  - Disregarding Foreign Acquiring stock attributable to excessive passive assets
  - Serial inversions
  - Third-country transactions
  - Domestic Entity "non-ordinary course distributions" ("NOCDs")
  - Application of the EAG rules to subsequent transfers of Foreign Acquiring stock
  - Modifications to SBA Exception and the Inversion Gain regime

Temporary Section 7874 Regulations: Overview

- What's New
  - Multiple-step rules that treat certain subsequent acquisitions of Foreign Acquiring as a Domestic Entity Acquisition
  - Rules disregarding Foreign Acquiring stock issued as consideration for prior Domestic Entity Acquisitions
  - Minor clarifications to the SBA Exception
- What's Different?
  - Application of the EAG rules to subsequent Foreign Acquiring stock transfers in the context of domestic-parented organizations
  - NOCD calculation
  - Modification of the rules addressing so-called "third-country transactions"
  - Determination of whether a lower-tier Foreign Acquiring has excessive passive assets and the amount of stock attributable to its passive assets does not take into account the assets of upstream or brother-sister EAG members

Multiple-Step Domestic Entity Acquisitions

Background

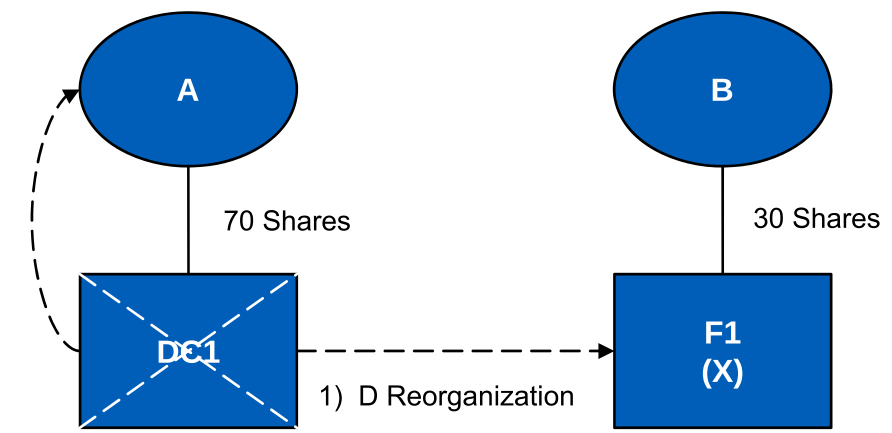
- The acquisition of a foreign corporation's stock generally is not treated as an indirect acquisition of its assets and, thus, the acquisition of a foreign parent corporation's stock generally is not treated as a Domestic Entity Acquisition of a Domestic Entity owned by the foreign parent corporation
- Treasury and the IRS nonetheless were concerned that taxpayers used this general rule to effect multiple-step transactions contrary to section 7874 policy:
  - Foreign Acquiring's EAG satisfies the SBA Exception, but is subsequently acquired by another foreign corporation organized in a jurisdiction in which the Foreign Acquiring EAG does not have substantial business activities
  - Foreign Acquiring is subsequently acquired by another foreign corporation that is tax resident in another jurisdiction (i.e., third-country transactions)

Overview – Treas. Reg. § 1.7874-2T

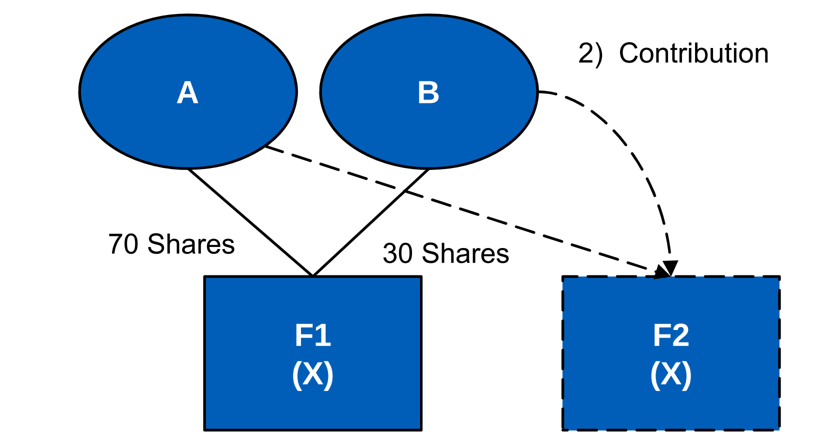
- **General Rule:** A "Subsequent Acquisition" is treated as a Domestic Entity Acquisition and the "Subsequent Acquiring Corporation" is treated as Foreign Acquiring
  - A Subsequent Acquisition is a transaction that occurs after and pursuant to the same plan as a Domestic Entity Acquisition in which a foreign corporation—i.e., the Subsequent Acquiring Corporation—acquires substantially all the properties held directly or indirectly by Foreign Acquiring
- The Subsequent Acquisition must be separately tested under section 7874 to determine whether the Subsequent Acquiring Corporation is a surrogate foreign corporation
  - Subsequent Acquiring Corporation stock is treated as held "by reason of" Domestic Entity stock/partnership interest if it is received by a former Foreign Acquiring shareholder in exchange for, or with respect to, Foreign Acquiring stock that was received in the Domestic Entity Acquisition "by reason of" the Domestic Entity stock/partnership interests
- Rule applies separately to each Subsequent Acquisition and the section 7874 treatment of a Subsequent Acquisition does not affect the section 7874 treatment of a preceding Domestic Entity Acquisition
- Rule is new, as it was not announced in the 2015 or 2014 Notice

Reg. § 1.7874-2T(k)(2), *Example 21*

Domestic Entity Acquisition



Subsequent Acquisition



Facts

1) DC1 effects a D reorganization with and into F1 by transferring all of its assets to F1 in exchange for 70 newly-issued shares of F1 voting stock

2) Pursuant to the same plan as Step 1, A and B form F2 and contribute to F2 their respective F1 stock holdings in exchange for a proportionate interest in F2—i.e., A and B own 70 shares and 30 shares, respectively, of F2's 100 outstanding shares

Analysis

- DC1's D reorganization with and into F1 is a Domestic Entity Acquisition
  - F1 is Foreign Acquiring
  - A's 70 shares of F1 stock are "by reason of" holding shares of DC1
- The contribution of F1 stock to F2 is a Subsequent Acquisition because it is completed pursuant to the same plan as DC1's D reorganization and F2, the Subsequent Acquiring Corporation, indirectly acquires all of F1's properties on account of acquiring its stock
- The contribution is treated as a Domestic Entity Acquisition
  - F2 is Foreign Acquiring
  - A's 70 shares of F2 stock are considered received by reason of holding shares of DC1
  - Ownership Fraction: 70/100

Serial Inversions

Background

- Historically, the determination of whether section 7874 applies to multiple Domestic Entity Acquisitions by the same Foreign Acquiring was made on an acquisition-by-acquisition basis, unless the multiple acquisitions occurred pursuant to the same plan
- Treasury and the IRS are concerned that a single Foreign Acquiring can avoid section 7874 by completing multiple Domestic Entity Acquisitions over a relatively short period of time
  - Foreign Acquiring's value increases with each successive Domestic Entity Acquisition, which allows Foreign Acquiring to complete subsequent, potentially larger, Domestic Entity Acquisition
  - The Ownership Percentage in the subsequent Domestic Entity Acquisition is decreased by the value of Foreign Acquiring attributable to the initial Domestic Entity Acquisition
- Treasury and the IRS determined its contrary to section 7874 policy to permit the Ownership Percentage to be decreased by Foreign Acquiring stock issued in other recent Domestic Entity Acquisitions

Overview – Treas. Reg. § 1.7874-8T

- **General Rule:** With respect to a Domestic Entity Acquisition (the "Relevant Domestic Entity Acquisition"), Foreign Acquiring stock is disregarded—i.e., excluded from the Ownership Fraction denominator—if it was issued in a "Prior Domestic Entity Acquisition" (the "Total Excluded Amount")
- Total Excluded Amount
  - Equal to the sum of the Excluded Amounts for each Prior Domestic Entity Acquisition
  - The Excluded Amount with respect to each Prior Domestic Entity Acquisition is computed separately for each "Relevant Share Class" and is equal to the product of:
    - "Total Number of Prior Acquisition Shares" less the sum of the "Number of Allocable Redeemed Shares" for all "Redemption Testing Periods" and
    - The fair market value of a single share of stock of the Relevant Share Class on the date the Relevant Domestic Entity Acquisition and all related transactions are completed
- Rule is new, as it was not announced in either of the notices

Prior Domestic Entity Acquisition

- Definition: A Domestic Entity Acquisition that occurred within the 36-month period ending on the date the Relevant Domestic Entity Acquisition is a "binding contract"
- De minimis Exception: A Domestic Entity Acquisition is not a Prior Domestic Entity Acquisition if:
  - The Ownership Percentage was less than 5% (vote and value), and
  - The value of the Foreign Acquiring stock received "by reason of" the Domestic Entity stock/partnership interests was less than $50 million

Relevant Share Class

- Definition: Each separate legal class of shares that were received "by reason of" the Domestic Entity stock/partnership interests in the Prior Domestic Entity Acquisition (such shares, the "Prior Acquisition Shares")
- Determined without regard to whether the Prior Domestic Entity Acquisition was an Inversion Transaction
  - Thus, subject to the de minimis exception, Foreign Acquiring stock issued in connection with a smaller Domestic Entity Acquisition—i.e., a direct/indirect "substantially all" acquisition—is subject to this rule
- Adjusted for subsequent Foreign Acquiring capital adjustments (e.g., splits, stock distributions, and recapitalizations)

Allocable Redeemed Shares

- Determined separately for each Redemption Testing Period and is equal to the product of (i) Shares redeemed (section 317(b)) during the Redemption Testing Period, and (ii) the "<u>Redemption Fraction</u>"
- Redemption Fraction:

$$\frac{\left(\begin{array}{c}\text{Total Prior Acquisition Shares}\\ -\text{ Allocable Redeemed Shares for all prior Redemption Testing Periods}\end{array}\right)}{\left(\begin{array}{c}\text{Outstanding Foreign Acquiring shares at the end of the Redemption Testing Period}\\ +\text{ Redeemed Shares during the Redemption Testing Period}\end{array}\right)}$$

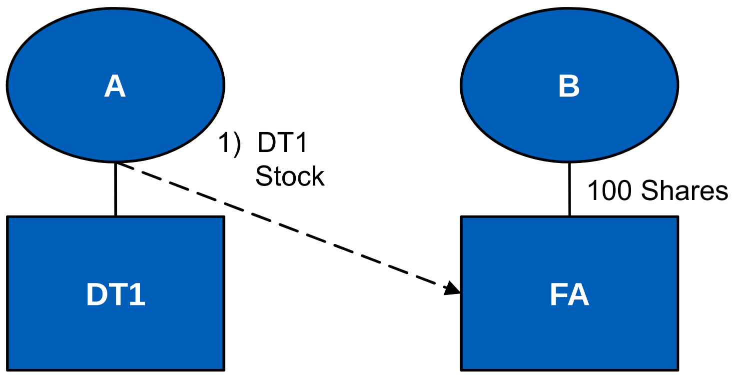
- Appropriate adjustments must be made to account for changes in Foreign Acquiring's capital structure (e.g., splits, stock distributions, and recapitalizations)

Redemption Testing Periods

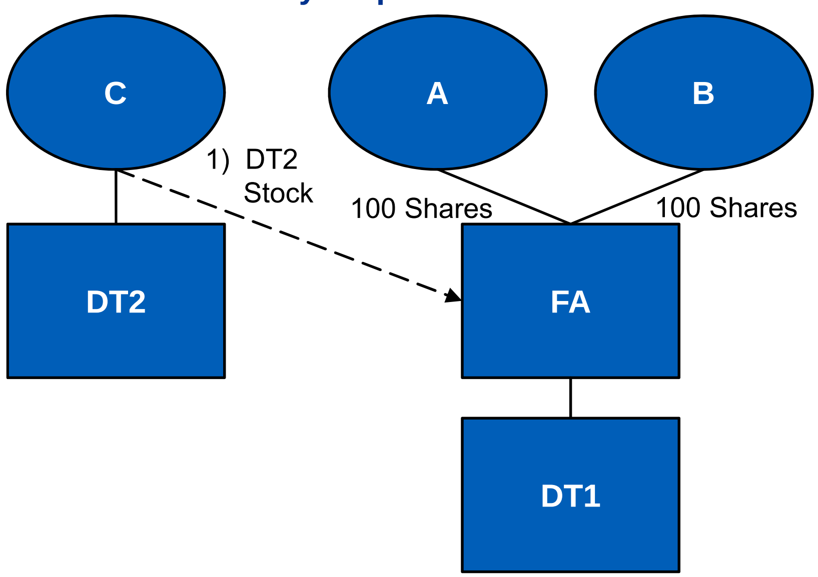
- Definition: The period:
  - Beginning the day after the Prior Domestic Entity Acquisition and all related transactions were completed, and
  - Ending on the day before the Relevant Domestic Entity Acquisition and all related transactions are completed
- Exception: Foreign Acquiring may establish a “reasonable method” for dividing a Redemption Testing Period into shorter periods
  - A reasonable method includes a method based on a calendar convention (e.g., quarterly or yearly)
  - A method is only reasonable if it is consistently applied to all Prior Domestic Entity Acquisitions and all Relevant Share Classes

Treas. Reg. § 1.7874-8T(h), Example 1

Prior Domestic Entity Acquisition



Relevant Domestic Entity Acquisition



Facts

1) In Year 1, A transfers all of its DT1 stock to FA in exchange for 100 newly-issued shares of FA stock (the "<u>DT1 Acquisition</u>"); each FA share has a value of \$1x when the DT1 Acquisition is completed

2) In Year 3 and in a separate transaction, FA enters into a binding contract to acquire all the stock of DT2 and, thereafter, acquires all the stock of DT2 in exchange for 150 newly-issued shares of FA stock (the "<u>DT2 Acquisition</u>"); each FA share has a value of \$1.50x when the DT2 Acquisition is completed

Analysis

- The DT1 Acquisition is a Prior Domestic Entity Acquisition with respect to the DT2 Acquisition, the Relevant Entity Acquisition
- Since FA did not have any capital structure changes, the Total Excluded Amount with respect to the DT1 Acquisition is equal to \$150 (100 x \$1.50)
- The Ownership Fraction with respect to the DT2 Acquisition is \$225/\$375 and, thus, the Ownership Percentage is 60%
  - Numerator: 150 x \$1.5 = \$225
  - Denominator: 350 x \$1.5 – \$150 = \$375
- <u>Note</u>: DT2 Acquisition's Ownership Percentage without regard to Treas. Reg. § 1.7874-8T would be 42.8% (\$225/\$525)

Out-From-Under Restructuring Transactions

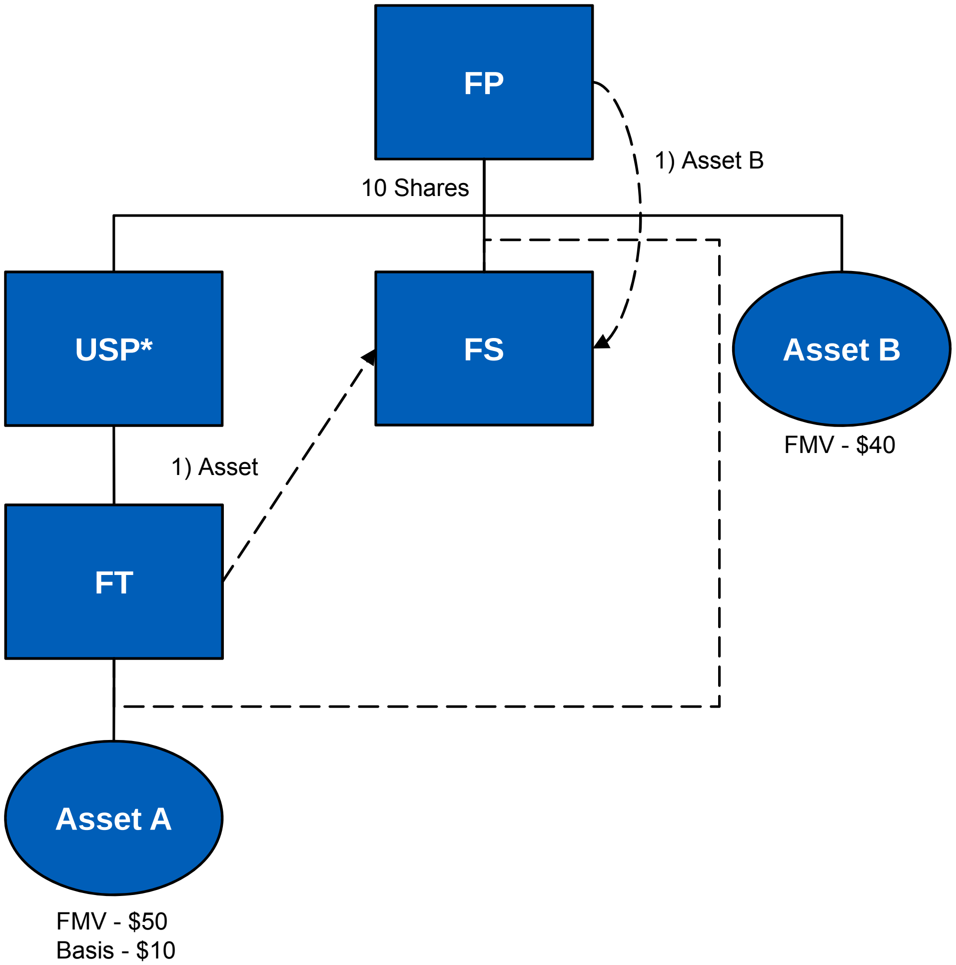
Overview

- Most of the rules are substantially similar to the rules contained in the 2014 Notice and 2015 Notice:
  - Treating certain post-Inversion Transaction CFC “hopscotch” investments as “U.S. property” for section 956 purposes
  - Re-characterizing or requiring income recognition with respect to certain post-Inversion Transaction dilution investments in CFCs
  - Modifications to section 304(b)(5)(B)’s “more than 50%” test
- What’s New?
  - Rules requiring a CFC to recognize gain on certain post-Inversion Transaction section 351 asset transfers
  - Rules preventing the application of the section 956 short-term liquidity exceptions to certain post-Inversion Transaction related-party loans

Post-Inversion Transaction CFC Asset Transfers – Treas. Reg. § 1.367-4T(f)

- **General Rule:** If, during the Applicable Period, an "Expatriated Foreign Subsidiary" transfers "Specified Property" to a foreign corporation in a section 351 exchange, the Expatriated Foreign Subsidiary must recognize all realized gain in the Specified Property that would not otherwise be recognized
  - An Expatriated Foreign Subsidiary generally is a CFC in which an Expatriated Entity is a U.S. shareholder (as defined by section 951(b))
  - Specified Property means any property other than stock of a lower-tier Expatriated Foreign Subsidiary
- De Minimis Exception: The general rule does not apply to a transfer if:
  - Immediately after the transfer, the transferee foreign corporation is a CFC, and
  - The Post-Exchange Ownership Percentage with respect to the transferee foreign corporation is at least 90% of the Pre-Exchange Ownership Percentage with respect to the Expatriated Foreign Subsidiary

Treas. Reg. § 1.367-4T(f)(3), Example 1



**FP acquired USP in an Inversion Transaction on July 1, 2016*

Facts

1) During the Applicable Period, FT and FP transfer Asset A and Asset B, respectively, to FS in section 351 exchange for 50 FS shares and 40 FS shares, respectively; FP originally owned 10 shares of FS stock prior to the exchange

Analysis

- FT must recognize all $40 of gain in Asset A
  - Asset A is Specified Property because it is not stock in a lower-tier Expatriated Foreign Subsidiary
  - FT transferred Asset A to FS, a foreign corporation, in a transaction described in section 351
- FT's 50 FS shares are an investment in U.S. property under Treas. Reg. § 1.956-2T(a)(4)(i)
  - FT has fair market value basis in the shares and $40 of E&P

Proposed Section 385 Regulations

Section 385: In General

- Section 385(a) provides Treasury with the authority to issue regulations as may be necessary or appropriate to:
  - Determine whether an instrument is debt or equity for U.S. tax purposes, and
  - Bifurcate an instrument as part debt and part equity
- Section 385(b) includes a non-exhaustive list of factors that may be taken into account in determining whether an instrument is debt or equity for U.S. tax purposes
  - Whether the instrument includes a written unconditional promise to pay a sum certain and fixed interest rate
  - Whether the instrument is subordinated to, or given preference over, other indebtedness
  - The issuer’s debt-to-equity ratio
  - Whether the instrument is convertible into the issuer’s stock
  - The relationship between holding stock of the issuer and the instrument
- Section 385(c) states that the issuer’s characterization of an instrument at the time of issuance is binding on the holder, but not the IRS, unless the holder discloses the inconsistent treatment, and provides Treasury with authority to require information necessary to carryout the provisions of the subsection

Proposed Regulations: Overview

- **Bifurcation:** Provide the IRS with the ability to bifurcate an instrument as part debt and part stock
- **Documentation:** Set forth documentation, timing, and maintenance requirements that must be satisfied for a related-party instrument to be characterized as debt for U.S. tax purposes
- **Recharacterization:** Subject to certain exceptions, re-characterize related-party debt instruments as stock for all U.S. tax purposes when issued: (i) in a distribution, (ii) in exchange for related-party stock, (iii) as consideration in an internal asset reorganization, or (iv) to fund such transactions
- Consolidated Groups
  - Members of a U.S. consolidated group are treated as a single entity, so the regulations do not apply to debt between consolidated group members
  - Provide treatment for when related-party debt comes into or leaves a U.S. consolidated group
- Apply without regard to whether:
  - The parties are domestic or foreign, or
  - The corporate group effected an inversion

Proposed Regulations: Overview

- **Documentation** and **recharacterization provisions** generally apply to an "Applicable Instrument," which is defined as any interest issued or deemed issued that is in form debt, that is an "Expanded Group Instrument" (or "EGI")
  - An "EGI" is an Applicable Instrument the issuer and holder of which are members of the same "Expanded Group" (or "EG")
  - An "EG" is a section 1504(a) affiliated group determined
    - Without regard to section 1504(b)
    - Changing the requisite ownership measurement to vote ***or*** value
    - Allowing the common parent to own directly ***or indirectly (determined using section 304(c)(3))*** at least 80% of the vote or value of at least one includible corporation
- **Documentation provisions** only apply to large taxpayer groups (publicly-traded, more than $100 million total assets, or more than $50 million in annual revenue)

Proposed Regulations: Overview – Documentation Required

- The documentation required under Prop. Reg. § 1.385-2(b)(2) included written documentation evidencing:
  - An unconditional obligation to pay a sum certain
  - Creditor's rights
  - A reasonable expectation that the issuer intended to, and would be able to, repay the EGI
  - Payments of principal or interest (or, in the event of default, a holder's reasonable exercise of diligence and judgment of a creditor)
- The required documentation must be timely prepared in accordance with detailed timing rules provided under Prop. Reg. § 1.385-2(b)(3)
- Special rules apply for (i) revolving credit agreements and similar agreements and (ii) cash pooling arrangements
- The required documentation must be maintained for all taxable years that the EGI is outstanding and until the period of limitations expires for any return with respect to which the treatment of the EGI is relevant

Proposed Regulations: Overview

- **Bifurcation provisions** apply to an Applicable Instrument the issuer and holder of which are members of the same "Modified Expanded Group" (or "Modified EG")—i.e., an EGI but substituting "Modified EG" for "EG"
  - A "Modified EG" is an EG determined by lowering the ownership threshold to "at least ***50%*** vote or value"
    - A partnership is a member of a Modified EG if one or more Modified EG members directly or indirectly (determined using section 304(c)(3)) own at least 50% of the partnership's capital or profits interests
    - A person is treated as a Modified EG member if it is treated as owning at least 50% of the value of the Modified EG member under section 318

Proposed Regulations: Overview – Effective Dates

- The **documentation** and **bifurcation provisions** are generally effective for Applicable Instruments issued or deemed issued after the regulations are published as final
- The **re-characterization provisions** (including those addressing the treatment of U.S. consolidated groups) are generally effective for EG "Debt Instruments"—i.e., an interest treated as debt under section 1275(a) and Treas. Reg. § 1.1275-1(d)—issued on or after April 4, 2016, and to any Debt Instrument treated as issued before April 4, 2016, as a result of a check-the-box election filed on or after April 4, 2016
- The **re-characterization provisions**, however, include limited transition rules that provide that a Debt Instrument issued before the regulations are finalized and that would be recharacterized as stock under the regulations is treated as debt only for the 90 days after the regulations are finalized; on the 91st day any outstanding instruments are deemed exchanged for stock
- Refinancing of pre-effective date debt is affected and consider treatment of substantial modifications of debt instruments under Treas. Reg. § 1.1001-3

Recharacterization Provisions

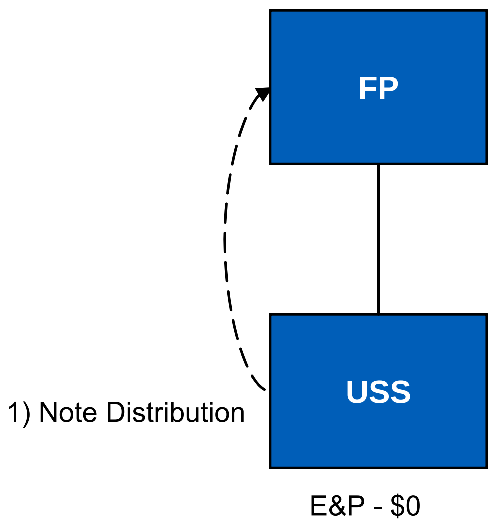
Overview

- Provides rules that treat as stock certain Debt Instruments issued to EG members that would otherwise be treated as debt for U.S. tax purposes
  - Generally applies to intra-EG transactions in which debt is issued in form without a new capital investment
  - A Debt Instrument, or portion thereof, treated as stock under the provisions is treated as such for all U.S. tax purposes
- Includes two primary operating rules: the "<u>General Rule</u>" and the "<u>Funding Rule</u>," each of

General Rule

- Unless an exception applies, a Debt Instrument issued by a corporation to an EG member is treated as stock if it is issued:
  - In a "Distribution,"
  - In exchange for the stock of a member of the same EG ("EG Stock") (other than an issuance in an "Exempt Exchange")) or
  - In exchange for property in an asset reorganization if the instrument is received, pursuant to the plan of reorganization, by a transferor corporation shareholder that is an EG member with respect to its transferor corporation stock
- A "Distribution" is any distribution made by a corporation with respect to its stock
- An "Exempt Exchange" is an EG Stock acquisition in which the transferor and transferee are parties to an asset reorganization and either:
  - Section 361(a)/(b) applies to the transferor and the stock is not transferred by issuance, or
  - Section 1032 or Treas. Reg. § 1.1032-2 applies to the transferor and the stock is distributed to the transferee pursuant to the plan of reorganization

General Rule – Example 1: Note Distribution



Assumption: No exceptions to the general rule are applicable

Facts

1) In Year 1, when USS has no current or accumulated E&P, USS distributes a note to FP (alternatively, USS has E&P but FP is in a jurisdiction with a US tax treaty providing for no withholding tax on dividends)

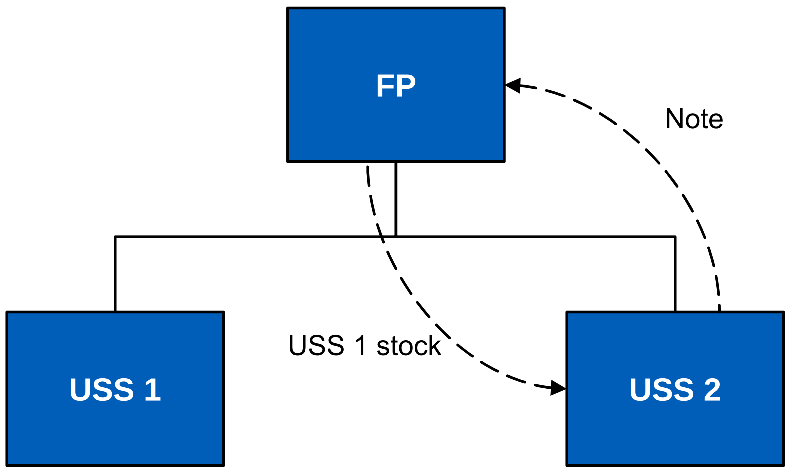
Issues

- Absent the application of the Proposed Regulations, Year 1 note distribution is not taxable (section 301(c)(3) gain, if any, not subject to U.S. tax so long as USS not a USRPHC)
- Interest payments reduce U.S. tax base and the principal can be repaid without U.S. tax

Result under General Rule

- *See* Prop. Reg. § 1.385-3(b)(2)(i) and (g)(3), Example 1
- Preamble, Section VI.C.2: "In many contexts, a distribution of a debt instrument…lacks meaningful non-tax significance, such that respecting the debt instrument as indebtedness for federal tax purposes produces inappropriate results"

General Rule – Example 2: Section 304 Transaction



Assumption: No exceptions to the general rule are applicable

Facts

1) USS 2 acquires the stock of USS 1 from FP in exchange for a note (assume that either (i) neither USS 1 nor USS 2 has any current or accumulated E&P, or (ii) either USS 1 or USS 2 has E&P but FP is in a jurisdiction with a US tax treaty providing for no withholding tax on dividends)

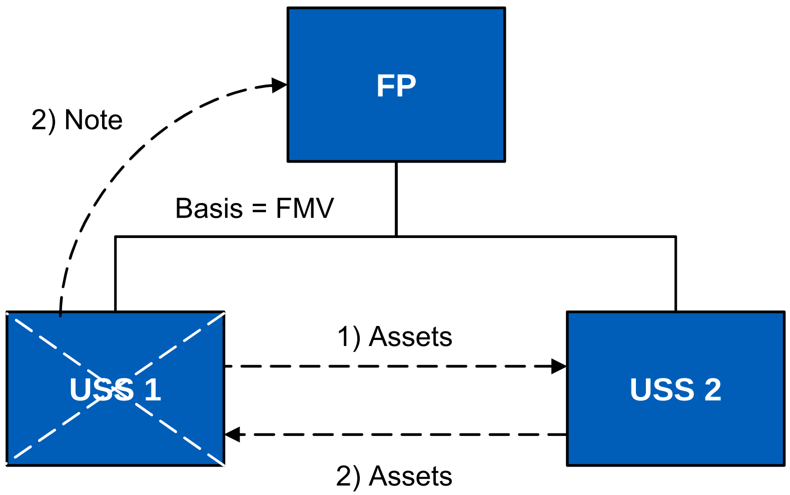
Issues

- Absent the application of the Proposed Regulations, the transaction would constitute a dividend-equivalent section 304(a)(1) transaction that is not taxable (section 301(c)(3) gain, if any, not subject to U.S. tax so long as USS 2 not a USRPHC)
- Interest payments reduce U.S. tax base and the principal can be repaid without U.S. tax

Result under General Rule

- *See* Prop. Reg. § 1.385-3(b)(2)(ii) and (g)(3), Example 3
- Preamble, Section VI.C.3: "the issuance of a related-party debt instrument to acquire stock of a related person is similar in many respects to a distribution of a debt instrument and implicates similar policy considerations"

General Rule – Example 3: All Boot D Reorganization



Assumption: No exceptions to the general rule are applicable

Facts

1) USS 1 transfers all of its assets and liabilities to USS 2 in exchange for a note in a transaction that qualifies as a reorganization under section 368(a)(1)(D)

2) Pursuant to the plan of reorganization, USS 1 distributes the note to FP in liquidation. FP has a tax basis in its USS 1 stock equal to fair market value

Issues

- Absent the application of the Proposed Regulations, the "dividend-within-gain" limitation of section 356(a)(2) prevents any of the note distribution from being treated as a dividend
- Interest payments reduce U.S. tax base and the principal can be repaid without U.S. tax

Result under General Rule

- *See* Prop. Reg. § 1.385-3(b)(2)(iii) and (g)(3), Example 8; *see also* Example in Preamble, Section VI.C.4
- Preamble, Section VI.C.4: "[i]nternal asset reorganizations can operate in a similar manner to section 304 transactions as a device to convert what otherwise would be a distribution into a sale or exchange transaction without having any meaningful non-tax effect"

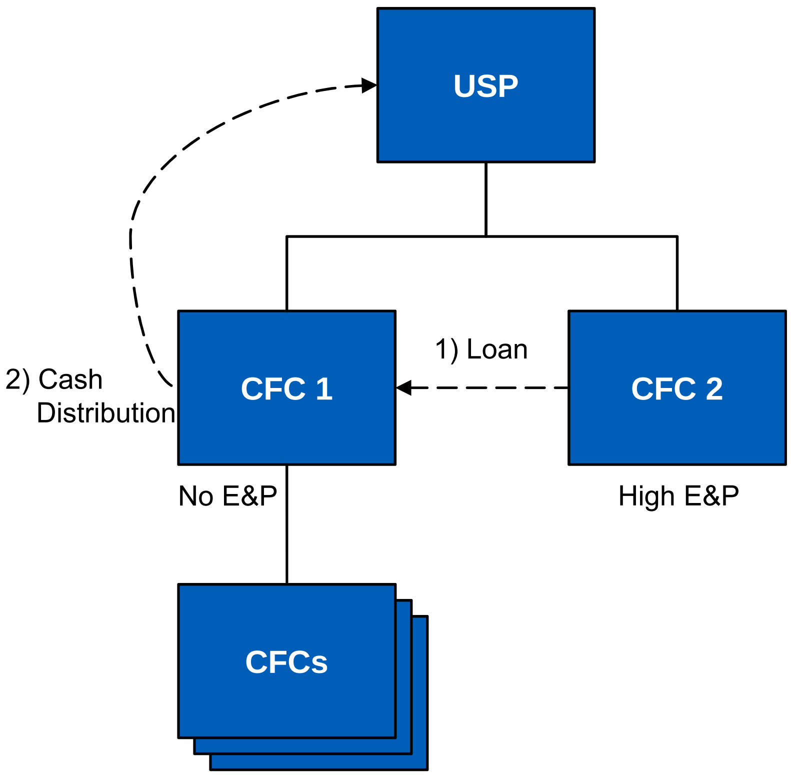
Funding Rule: Overview

- A Debt Instrument is treated as stock if it is "Principal Purpose Debt Instrument"
- A "Principal Purpose Debt Instrument" is a Debt Instrument issued by a corporation (the "Funded Member") to an EG member in exchange for property ***with a principal purpose*** of funding one of the following distributions or acquisitions (the "Prohibited Distributions and Acquisitions"):
  - A Distribution of property by the Funded Member to an EG member, other than a Distribution of (i) stock in an asset reorganization without gain or income recognition under section 354(a)(1) or 355(a)(1) or (ii) when section 356 applies, "other property" or money
  - An acquisition of EG Stock (except in an Exempt Exchange) by the Funded Member from an EG member in exchange for property other than EG Stock, or
  - An acquisition of property by the Funded Member in an asset reorganization to the extent that pursuant to the plan of reorganization, a transferor corporation shareholder that is an EG member receives "other property" or money within the meaning of section 356 with respect to its transferor corporation stock
- For purposes of the Funding Rule, references to the "Funded Member" include references to any "predecessors" and "successors" of the Funded Member

Funding Rule: Principal Purpose Determination

- Unless the "Per Se Rule" applies, the determination of whether a Debt Instrument is a Principal Purpose Debt Instrument is made based on all facts and circumstances
- A Debt Instrument can be a Principal Purpose Debt Instrument regardless of whether it is issued before or after a Prohibited Distribution or Acquisition
- Per Se Rule (Non-rebuttable and is not a safe harbor)
  - Unless the exception for ordinary course transactions applies, a Debt Instrument is treated as a Principal Purpose Debt Instrument if it is issued by the Funded Member during the 72-month period beginning 36 months before the date of the Prohibited Distribution or Acquisition
- If two or more Debt Instruments can be a Principal Purpose Debt Instrument, the instruments are tested on a FIFO basis
- The Debt Instrument generally is treated as funding such distributions or acquisitions on a FIFO basis
- Funding Rule by its terms could still apply to any debt issued with a **principal purpose** of funding a de-funding transaction outside of the 72-month period

Funding Rule – Example 1: Leveraged Distribution



Assumption: No exceptions to the funding rule are applicable

Facts

1) CFC 2 has substantial cash and E&P. CFC 1 has no E&P. CFC 2 lends cash to CFC 1
2) CFC 1 distributes cash to USP. Assume USP's basis in its CFC1 stock exceeds the distribution amount (and there are no basis blocks)

Issues

- The loan from CFC 2 to CFC 1 supplies cash to CFC 1 without a corresponding movement of CFC 2's E&P
- Most/all of the distribution could be a tax-free return of basis
- Preamble, Section VI.C.5: "[i]ssuances of debt instruments to an affiliate in order to fund a distribution of property…often confer significant federal tax benefits without having a significant non-tax impact"
- *See* Prop. Reg. § 1.385-3(b)(3)(ii)(A) and (g)(3), Example 4
- <u>Query</u>: How does treating CFC 2 loan to CFC 1 as stock change the above return of capital results? Compare a case where USP is foreign and CFC 1 is domestic. Should special rules apply where the borrowing or lending is pursuant to a cash sweep or similar arrangement?

Funding Rule: Predecessors, Successors and Other Rules

- The Funding Rule also contains provisions addressing “predecessor” and “successor” corporations:
  - A predecessor generally includes the distributor or transferor corporation in a section 381(a) transaction in which the corporation is the acquiring corporation
  - A successor generally includes the acquiring corporation in a section 381(a) transaction in which the corporation is the distributor or transferor corporation
- In addition, for purposes of applying the General Rule, the Funding Rule and the consolidated group rules, an anti-abuse rule applies that treats a debt instrument as stock if it is issued with a principal purpose of avoiding the application of those rules
- There are also rules that coordinate the application of the General Rule and the Funding Rule to keep a single transaction from being subject to both rules
- A Debt Instrument treated as stock under the Funding Rule is generally treated as such when issued (the “<u>General Timing Rule</u>”)

General Rule and Funding Rule Exceptions

- "Current Year E&P Exception"
  - The amount of any distributions or acquisitions subject to the General Rule or Funding Rule are decreased by the amount of the in-question EG member's current year earnings and profits ("E&P")
  - The reduction is applied to the distributions or acquisitions in the order of occurrence
- "Threshold Exception"
  - A Debt Instrument is not treated as stock if immediately after its issuance, the aggregate adjusted issue price of Debt Instruments held by EG members that would otherwise be subject to the General Rule or the Funding Rule does not exceed $50 million
  - Once the $50 million threshold is exceeded, the Threshold Exception does not apply to any Debt Instrument issued by EG members so long as any Debt Instrument previously treated as debt under the Threshold Exception remains outstanding

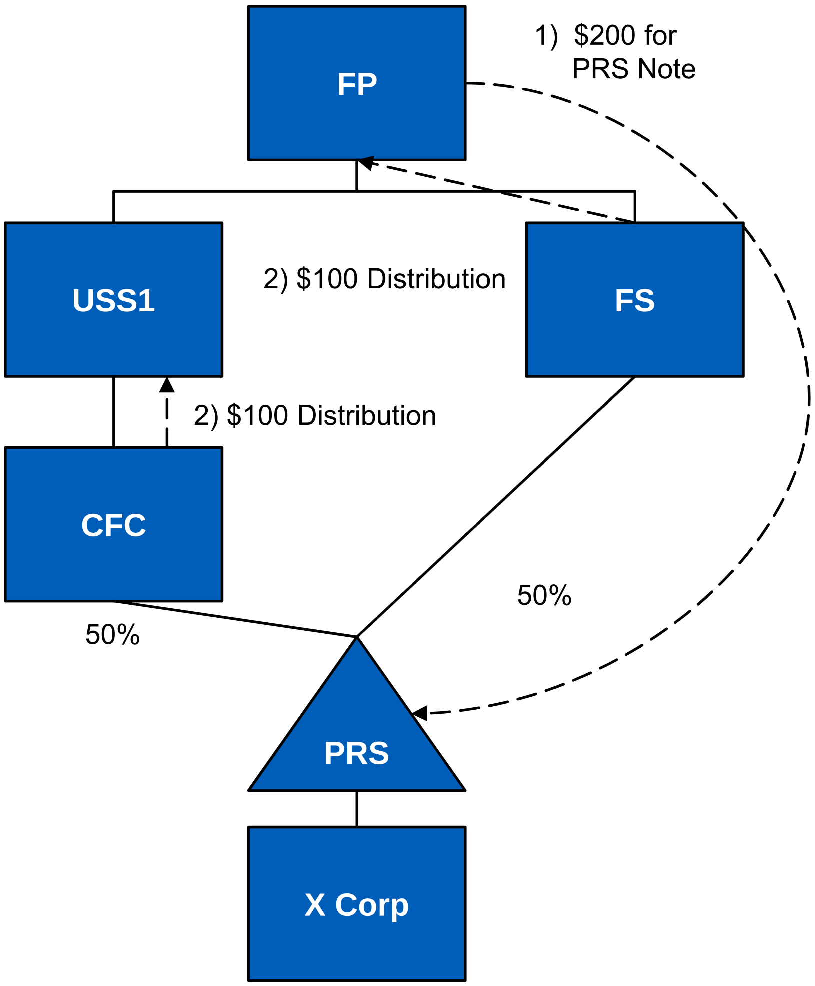
Funding Rule Exception

- “<u>Subsidiary Stock Issuance Exception</u>”
  - The acquisition of EG Stock is not a Prohibited Disposition of Acquisition if:
    - The acquisition results from a transfer of property by a Funded Member to another EG member (the “<u>Stock Issuer</u>”) in exchange for stock of the Stock Issuer (the “<u>Stock Issuance</u>”), provided that
    - The Funded Member holds, directly or indirectly, more than 50 percent of the Stock Issuer (as measured by vote and value) for the 36-month period immediately following the Stock Issuance
      - Indirect ownership is determined using the principles of section 958(a) without regard to whether an intermediate entity is foreign or domestic—i.e., a different standard than the section 304(c)(3) standard used elsewhere in the proposed section 358 regulations
  - If the Funded Member ceases to meet the 50 percent ownership requirement at any time during the 36-month period, the Subsidiary Stock Issuance Exception ceases to apply, and the EG Stock acquisition is subject to the Funding Rule

Controlled Partnership & DRE Debt Instruments

- If a Debt Instrument issued by a Controlled Partnership is treated as stock under the General Rule or the Funding Rule, then the holder of the Debt Instrument is treated as holding stock in the EG Partners
  - A "Controlled Partnership" is a partnership the capital or profits of which are directly or indirectly owned by EG members
  - The Controlled Partnership and its partners must make conforming adjustments to reflect this treatment
  - Any adjustments must be consistent with the purposes of Prop. Reg. § 1.385-3 and must be made in a manner that avoids the creation of, or increase in, a disparity between the Controlled Partnership's aggregate basis in its assets and the aggregate bases of the partners' respective partnership interests
- A Debt Instrument of a DRE that is treated as stock under Prop. Reg. § 1.385-3 is treated as stock of the DRE owner, not the DRE

Partnership Example



Assumptions

- The Threshold Exception, the Current Year E&P Exception, and the Ordinary Course Exception do not apply

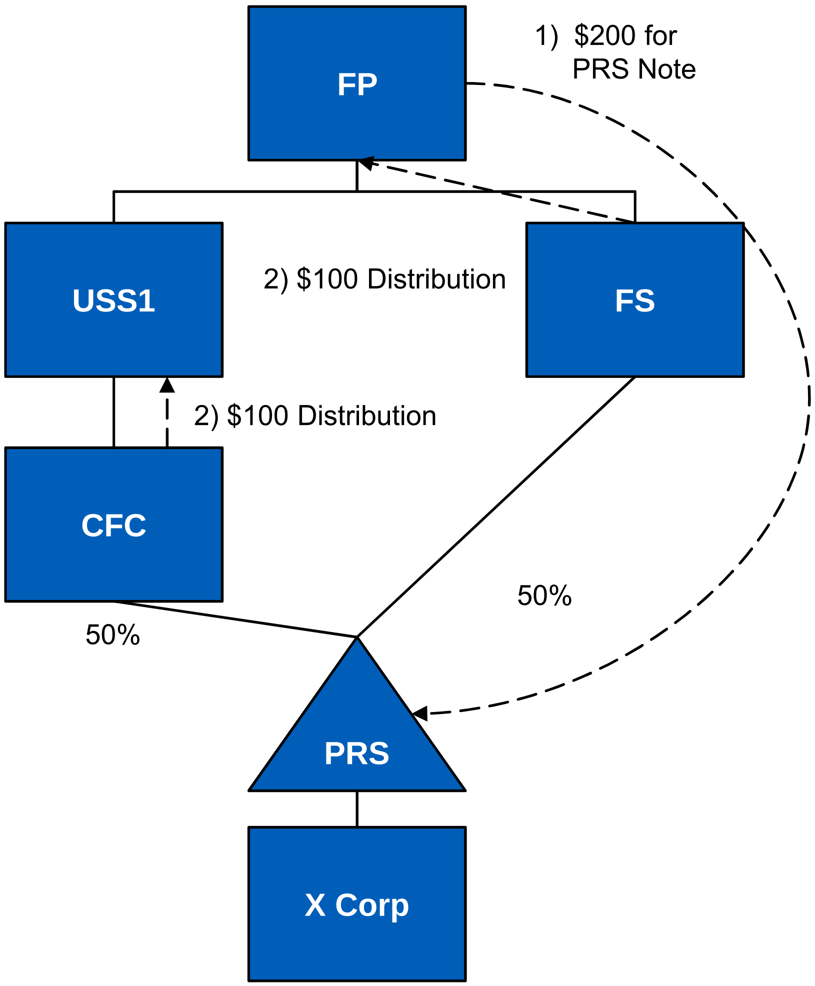
Facts

1) On Date A in Year 1, FP lends $200 to PRS in exchange for the PRS Note, a Debt Instrument
2) On Date B in Year 1, CFC distributes $100 to USS1 and FS distributes $100 to FP; CFC is not an "Expatriated Foreign Subsidiary" as defined in Treas. Reg. § 1.7874-12T(a)(9)

Analysis

- Because CFC and FS own 100% of the interests in PRS, PRS is a Controlled Partnership
  - As a result, under Prop. Reg. § 1.385-3(d)(5)(i), 50% of the PRS Note is treated as issued by each of CFC and FS
- The PRS Note is treated as $100 of CFC stock under the Funding Rule
  - The PRS Note is treated as a Principal Purpose Debt Instrument under the Per Se Rule because it was deemed issued by CFC, the Funded Member, to FP, an EG member, during the 72-month period beginning 36 months before Date B of Year 1—i.e., the date of CFC's distribution
  - Under the General Timing Rule, PRS Note is treated as CFC stock on Date A in Year 1—i.e., when its issued

Partnership Example (Continued)



Assumptions

- The Threshold Exception, the Current Year E&P Exception, and the Ordinary Course Exception do not apply

Analysis (continued)

- The PRS Note is treated as $100 of FS stock under the Funding Rule
  - The PRS Note is treated as a Principal Purpose Debt Instrument under the Per Se Rule because it was deemed issued by FS, the Funded Member, to FP, an EG member, during the 72-month period beginning 36 months before Date B of Year 1—i.e., the date of FS's distribution
  - Under the General Timing Rule, PRS Note is treated as FS stock on Date A in Year 1—i.e., when its issued
- Necessary Adjustments
  - Appropriate conforming adjustments must be made to CFC's and FS's interest in PRS to reflect the deemed treatment of the PRS Note
  - The adjustments must be done in a manner that avoids the creation of, or increase in, a disparity between inside and outside basis
  - Reasonable and appropriate adjustments may occur when the following steps are deemed to occur on Date A in Year 1: (i) CFC and FS each issue stock to FP in exchange for $100, and (ii) CFC and FS each contribute $100 to PRS for interests in PRS